DOW THEORY LETTERS INC.

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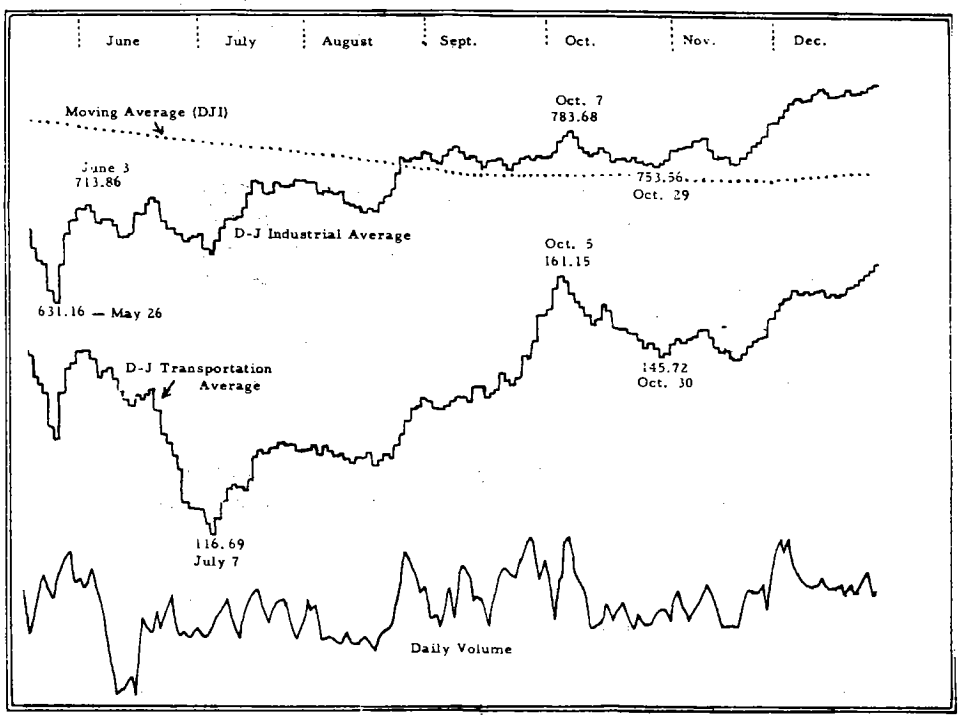
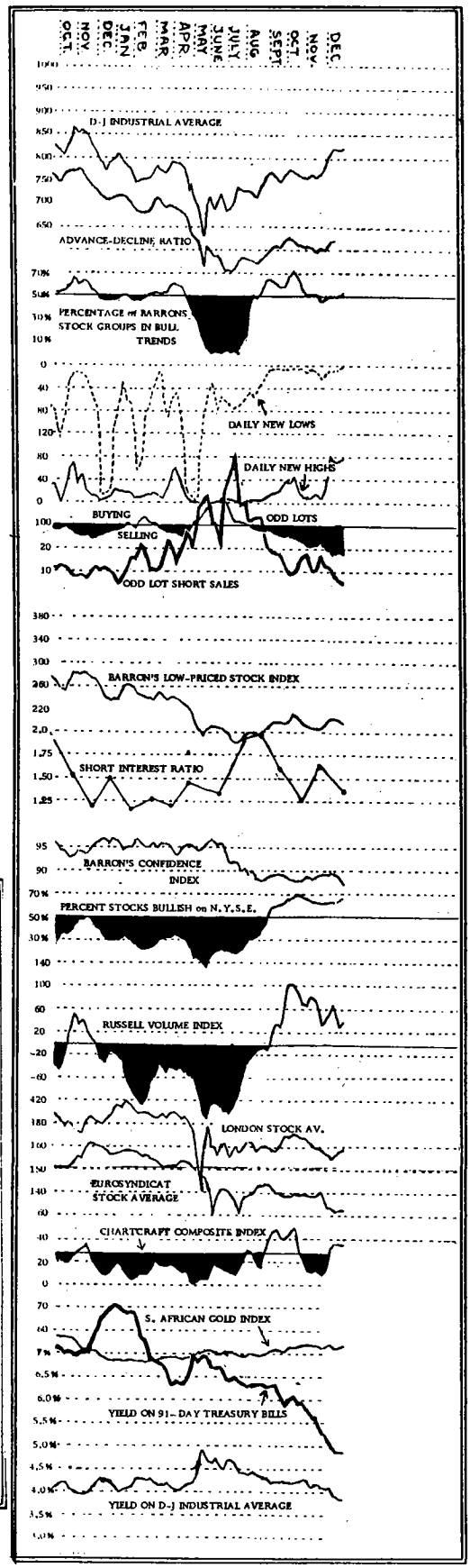
THE PICTURE: It looks like a $15 billion plus Federal deficit for 1971 and perhaps a $25 billion plus deficit for 1972. What would you do, as a Republican President, if your highly-touted "game plan" had collapsed, you had been forced to execute a complete about-face, and you then decided to stimulate the devil out of the economy so that everything would be boomy by 1972 election time? Well, one thing you wouldn't do is bring in a Secretary of the Treasury who knew anything about international finance. Because no one who knew what was going on would touch the job with a ten-foot pole.

So why not forget about the job itself, and at least go for the political angle. Texas has 26 fat electoral votes, and who knows, if everything goes right maybe the Lone Star residents will like a Texan right up there in Government and swing their votes to Mr. Nixon in the 1972 elections. So to every intelligent citizen's surprise, John Connally is our next Secretary of the Treasury.

What's the risk to Connally? If things fall apart he can always quit, denounce the "Republican mess", and run for Governor again. Besides, all Mr. Connally has to do, aside from his job of managing almost $400 billion of Government debt, is to convince a Democratic Congress that a Republican President wants more spending and "activity", prod Congress into providing spending, and with the other hand keep European Central bankers from completely panicking and trading in some of their mountain of U.S. dollars for what's left of our gold. Sounds easy? It's not going to be easy, and the Connally appointment appears to this observer to represent one of the most inept and cynical Presidential decisions I have seen in years.





The third week in December was marked by another significant event. As columnist Joseph R. Slevin put it, it was "....the first time that any President of the United States has gone out of his way to attend a celebration whose chief accomplishment was the glorification of a devastatingly cost inflation spiral." Mr. Slevin is referring, of course, to the Administration "gathering" which celebrated the "trillion dollar economy". This same gathering failed to mention that 1970, the first trillion dollar year, was characterized by an actual lower output of goods and was reached solely on inflation of prices.

The year 1971 will have to deal with the worst inflation in modern memory, and if the early indications mean anything, the inflation-dealing will be all of the wishy-washy variety. However, I personally believe that 1971 will be the year when the markets themselves deal with the problems of inflation, and the markets are not always wishy-washy (as witness 1969 and first half of 1970).

Mr. Alden Wells of Exeter, Mass. has had an excellent record of calling the shots in his monthly Monetary Reports. Mr. Wells is one of the very few men in this country who understands money and markets. In his latest (December 12) report, Mr. Wells makes the following prediction: "1971 looks like the year when profit margins, price, quality, capital investment, and employment will suffer severely. These trends, which became particularly noticeable in the last half of 1970, have to a large extent been built into our economic structure first by the government then government sponsored unions. Stockholders can look forward to an acceleration of the trend toward reduced or passed dividends".

In a later section of this report, Wells predicts ".....a continued decline in demand deposits and a slower rate of growth in currency. Under such conditions history should repeat, and the stock market decline to well below any level seen in the 1960's".

Which brings us to the problem of the stock market itself. At this point, I would like to go over a little history. The end of 1968 saw the Dow Industrials within 10 points of their all time high of 995.15. February 7, 1969, saw the Transportation Average at an all-time high of 279.88. Everything seemed primed for an ascent by the market into the stratosphere. But events didn't work out that way. Less than a year-and-a-half later, Industrials were at 630 and the Transportation Average was at 113. The rendez-vous with reality has been one of the most painful since the 1929 crash.

As I study the various factors, I am of the opinion that matters are considerably worse now than they were in late-1968 and early 1969. Inflation is worse, budget deficits (Federal, state and city) are worse, the public is less prone to buy, factory capacity is excessive, Europe is responding to U.S. economic policies less kindly, corporate liquidity is very low and corporate profit margins are in many cases precarious.

Nevertheless, the market recovery, following the drastic 1969-70 crash, continues. The recovery is raising false hopes and causing many to believe that a new bull market began in May, 1970. I feel that the optimists are going to suffer cruel disillusionment during 1971. The old bull market topped out almost five years ago (in February, 1966). The Dow has never been above that 1966 high, and a long, extended primary bear market has been in effect ever since that time.

Due to desperate, continued, often absurd Government interference, the bear market has been extended, held back, and all the while fed with new infusions of fiat money. But I want to warn that no Government has ever kept a primary bear market from fully expressing itself, from running to conclusion. The conclusion of this bear market is still far off; nothing has been corrected and nothing has been solved. The longer this rally lasts and the longer the counter-primary forces hold sway, the worse will be the final, crushing descent of the bear. I have little doubt that 1971 and 1972 are fated to see some of the worst markets in history. For the higher a ball is thrown, the faster the velocity when it descends and finally hits the earth. Gravity, in the current instance, is the force of the primary bear market itself. And the further the rally against those forces, the more violent and drastic the ultimate return to reality.

Getting to the current market, it is well to note that the end of the year is often a deceptive time. For instance, the years 1959, 1961, 1965 and 1968 were all marked by rising markets, markets that looked strong right through to the end of the year. Yet the market turned down at the beginning of 1960, 1962, 1966 and 1969, and each of those years brought sweeping declines.

Of the five years which have so far elapsed since the bear market began in February, 1966, two have been down years (1966 and 1969), two have been up years (1967 and 1968), and one has been rather split (1970) with most stocks in 1970 showing actual losses for the year. Events are drawing closer for the ultimate wind-up of this bear market, and I feel that 1971 will be both a deceptive year and that it will end up as a very costly year. The longer the bear "rests", the greater his potential power grows.

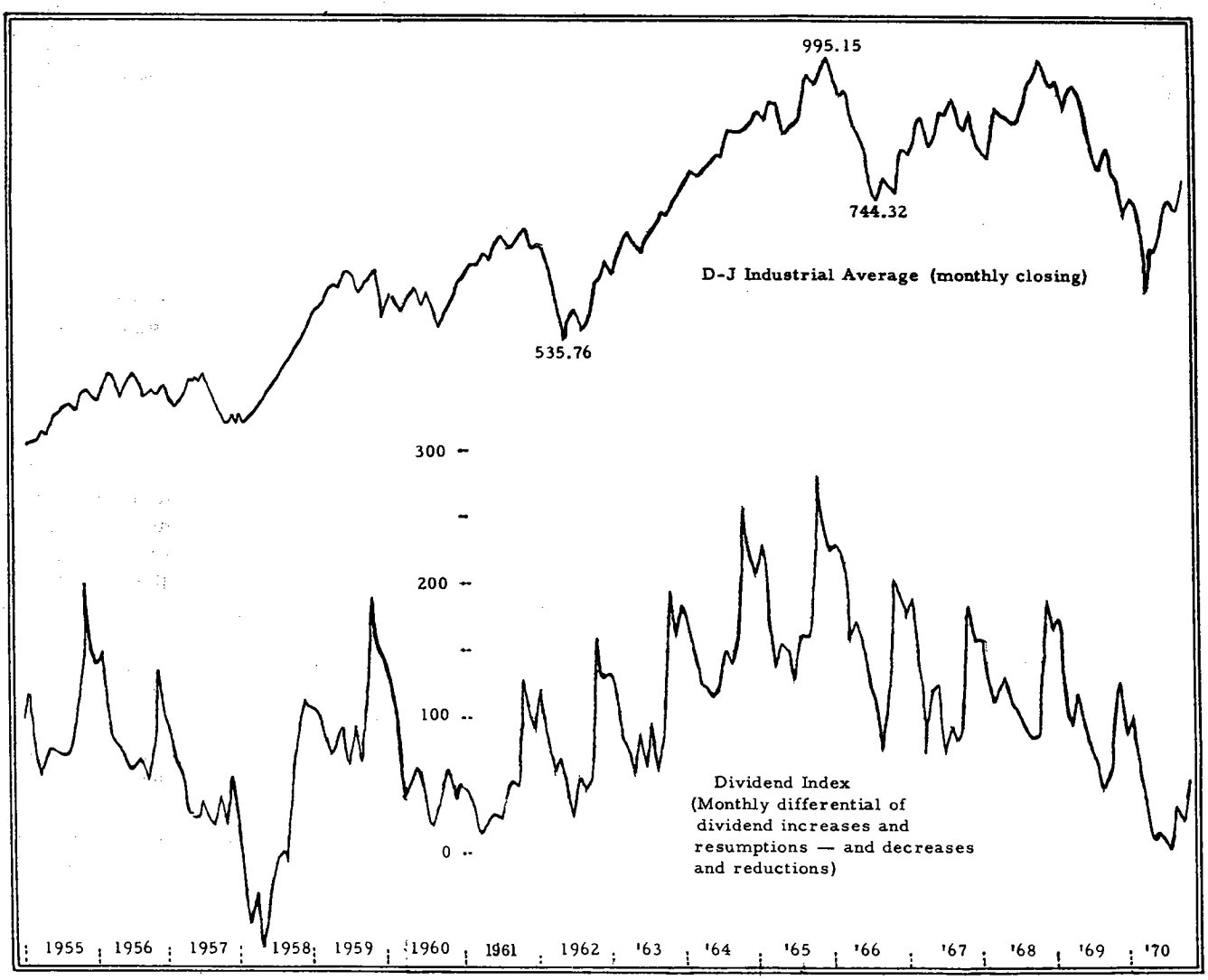
DIVIDENDS: I am including an up-dated chart of the dividend index, an indicator which I have presented in a few earlier Letters. This chart, staring with 1955, shows the monthly total of dividend increases and resumptions—minus dividend cuts and omissions. This is a study which I feel is absolutely fundamental for stock market appraisal.

Sooner or later an investment must provide a return to the buyer, otherwise the holder is dealing with what I term "perpetual potential". And perpetual potential, unfortunately, does not last forever. The usual form of actual return is a dividend. Common stocks, like every other form of investment, are basically judged on their return (i.e. dividend) and the trend of those dividends.

No market ever produced a long trend of dividend increases without going up. No market ever engaged in a long series of dividend decreases without going down. For when a corporation cuts or omits a dividend, it is saying something fundamental about the health of the company (in a negative way). The opposite can be said when a company lifts its dividend.

The monthly breakdown from Standard & Poor shows that the month of November, 1970, provided the fewest increases and resumptions in a decade (the November figure was 113). November also produced the largest number of decreases and omissions since 1962 (the figure was 49). The differential, 64, is charted as shown.

Note also that there is usually a seasonal spurt on the charted differentials towards the end of each year, followed by a sharp drop during the early part of the new year. The year 1970 produced a very sub-normal year-end rise in the Index. If 1971 brings the usual large first-quarter drop, the Index is sure to plunge under zero for the first time since 1958. This will mean that unfavorable dividend actions have finally surpassed favorable actions.



As the bear market progresses into its late stages, I expect dividend cuts and omissions to swell to record proportions. This will bring in an entirely new appraisal of common stock values (at least new for this generation), accompanied by bargain prices of the type not seen since the 1940's and early 1950's.

NOT EASY: In Letter 479 I included a large chart showing the Dow Industrials, the advance-decline ratio and the Quotron percentage change for all stocks on the N.Y.S.E. I noted that nothing was keeping up with the Dow on this recovery move within the framework of a primary bear market.

Since this bear market began in February, 1966, thousands of small investors have been wiped out. Others, finally doubting their ability to handle their accounts successively, have moved into mutual funds. It is therefore, rather interesting to examine the mutual fund record to see whether this avenue provides a haven from the ravages of the bear.

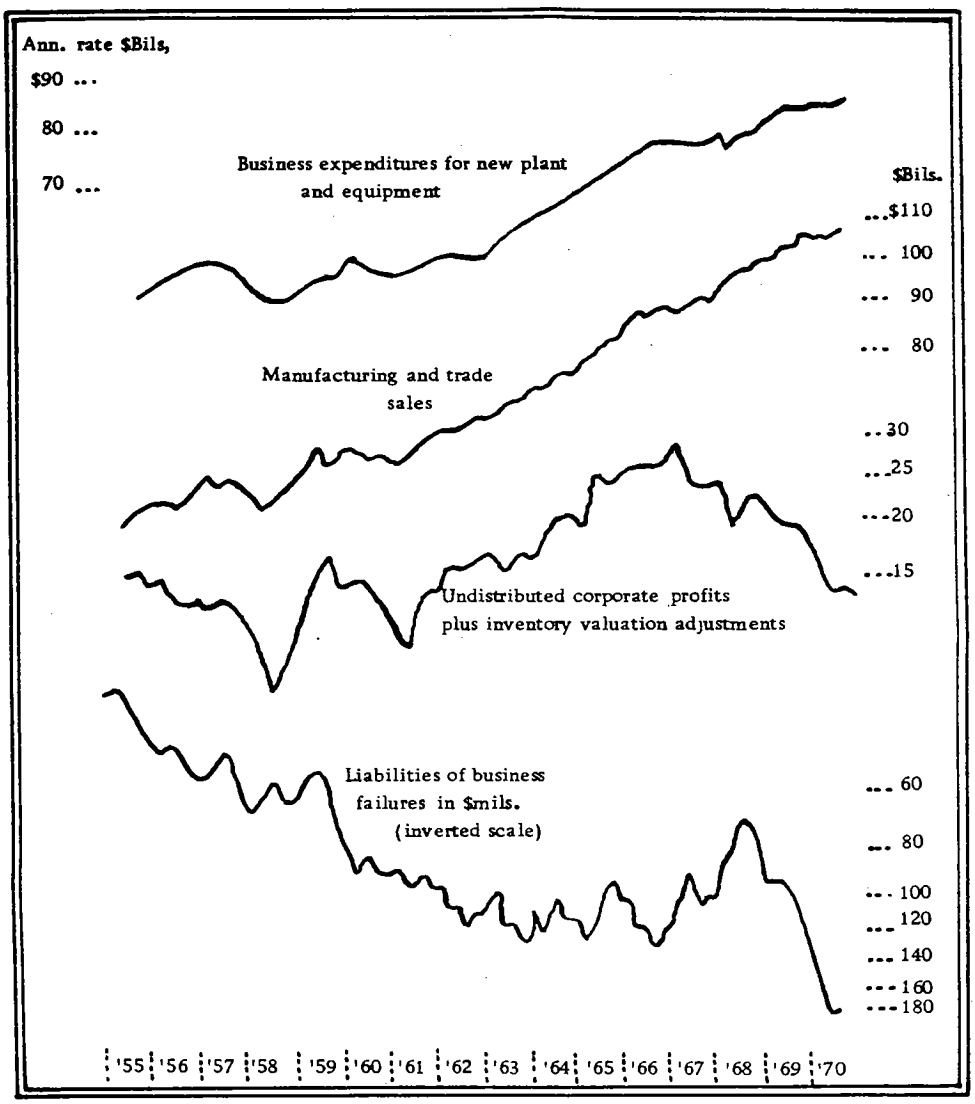
I include the latest Fund Indexes published by Arthur Lipper & Co., and here we see a rundown on the various catagories of funds and how they have fared percentagewise during 1970. Note that the Dow Industrials are actually up 2.8%. for the year (although the broader Standard & Poor 500 Stock Index is down 2.1%.

Yet of all 461 funds tabulated by Lipper, the average decline has been 11.36%. Of 299 growth-type funds, these are down a whopping 18.0%. The 24 balanced funds and the 42 income funds are both up. Note also that the very comprehensive N.Y.S.E. Index is off 5% and the lesser quality index of the American Exchange is off over 16%. Thus, in a bear market recovery which has taken the Dow Industrial Average above its January price, the great mass of funds have not done well, and the less-than-blue-chip stocks have not done well. All of which underscores my own, oft-repeated thesis that the best way to operate in a primary bear market is to stay out of it. Ask any fund manager, he knows.

FUND INDEXES

Following are Arthur Lipper & Co. mutuail fund indexes, including reinvestment of all distributions, for the week:

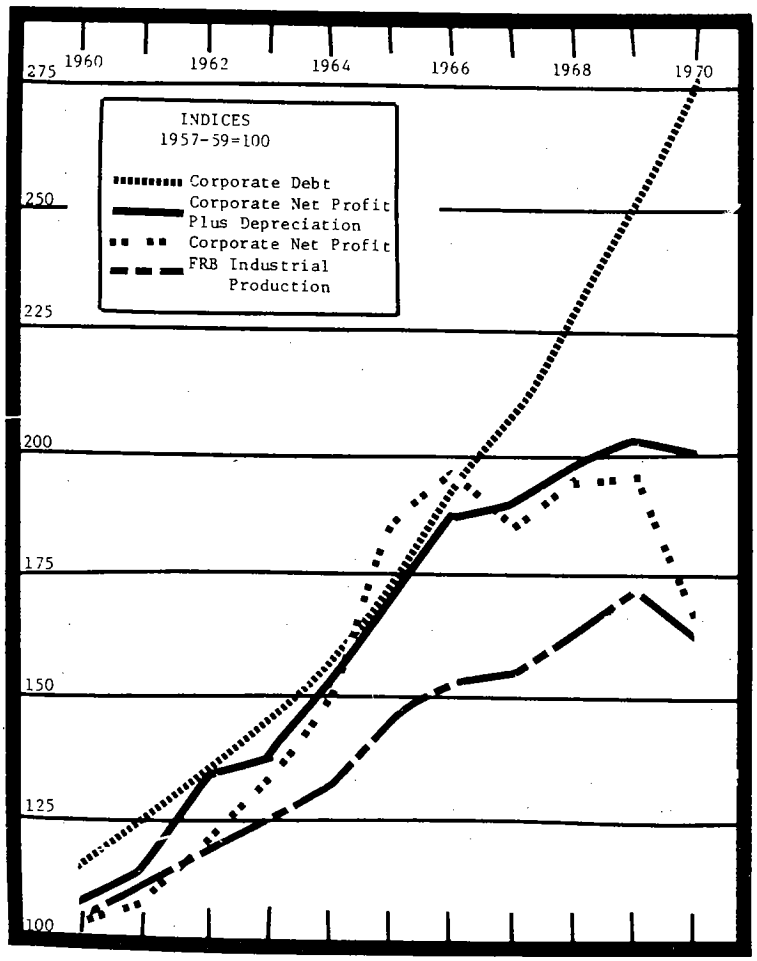
No. & Type of Fund	Per Cent Change Year to Dec. 23	Week ended Dec. 23
461 All Funds	— 11.36	+0.42
N.Y.S.E. Composite 49.06	— 4.79	+0.22
298 Growth	—18.07	+0.37
92 Growth & Income	— 1.17	+0.50
24 Balanced	+ 1.81	+0.40
43 Income	+ 5.13	+0.58
8 Bank & Insurance	— 5.67	+0.93
* *		
Dow Industrial 283.17	+ 2.84	+0.12
S&P 500 90.10	— 2.13	+0.09
S&P 425 98.70	— 2.75	+0.02
N.Y.S.E. Composite 49.06	—4.79	+0.22
Amex Index 22.22	—15.42	+0.82



ECONOMICS: Aside from my stock market studies, I do a great deal of reading in economics. After years of such activity, I have come to one major conclusion. Words are interesting and occasionally even informative, but I prefer charts. Charts cut through the verbiage like lightning through a storm. Tell me all about elephants, describe them backwards and forwards, fine. But I'd rather have five or ten good pictures of elephants. Those photos will tell me more about whan an elephant looks like than a dozen descriptive books.

I don't think I ever read a piece on economics when I don't find myself saying, "Blast it, why doesn't he give me a chart. I don't want to take his word or

his description of what's happening, I want to see the actual statistics charted as a trend."



I'm going to present a little economics in the form of two charts to my readers now, and I feel these two charts tell a real story. The first chart (right) includes tracings from the current "Business Conditions Digest" published by the Dept. of Commerce. The third indicator from the top was previously shown in Letter 469. It shows "undistributed corporate profits plus adjustment for inventory valuations", and this is another way of saying that it shows the changing net worth of American corporations in the form of retained profits. To put it succinctly, retained profits are in a declining trend, and that trend shows no signs of improving.

Now there are a number of ways of boosting retained earnings. A company can cut its dividends, it can cut its expenses, it can boost its sales and hopefully boost its profits, or it can jettison unprofitable divisions. As of now, corporations are trying all of these. None of them are easy to do, and of course boosting sales is not always within a corporation's ability.

So let's turn to the top line, "business expenditures for new plants and equipment". This sector is one of the backbones of any boom, it is the expenditures for capital goods. But already in the face of the drop in retained profits, this indicator is in trouble. For the backlog of capital appropriations has been declining all through 1970. With 25% of plant capacity now idle (see Letter 480) and with earnings being squeezed, corporations are not too prone to go out and build new plants and capacity. All of which hardly bespeaks of a boom in 1971-72.

The second indicator is "manufacturing and trade sales". This line has tended to level off since late-1969, and this is serious. For with shrinking profits, a corporation can often keep in the black simply by boosting volume. But if volume falls off substantially, expenses (many of which, such as debt, are fixed) tend to eat up the remaining profits. In other words, shrinking profits are bad, but shrinking profits plus declining sales volume can quickly put a corporation in the red.

That, in a nutshell, is why the Administration is frantically attempting to get the consumer to buy more. For if corporations are in a profit bind and capacity is already above what is needed, there is little the Administration can do with that sector. Therefore, it is up to the consumer to spend his head off and bail out the economy. But so far, there is little actual evidence to suggest that the consumer is ready to oblige. In fact, with mounting inflation and unemployment, the consumer is scared to death.

Finally, on the bottom of the page we see a rather ominous result of all this. It is "the liabilities of business failures" or the totals of dollars connected with corporate bankruptcies. This index is inverted so that the greater the total bankruptcy amounts, the lower the line goes. And as seen on the chart, the bankruptcy totals are mounting and mounting. So the Administration economists can guess all they want and wish all they want. Personally, I follow the economic charts, and I don't see anything particularly hopeful as of this writing.

The next economic chart is from Edward C. Delahay's fine analysis (published in November) for Gilbert M. Haas & Co. Here we see a graph which is almost self-explanatory. All four lines are readily comparable since they are based on the 1957-59 equalling 100. The thing to note here is the widening space between corporate profits and corporate debt. For while corporate debt is continuing to rocket, profits are sagging. Now rising debt is all right— if profits are heading up, for rising profits mean an ability to cover the cost of increased debt. But let debt rise while profits are declining and you face an increasingly serious dilemma. Increased debt in the face of declining earnings means a liquidity squeeze or a scramble for money to service the debt. When the scramble doesn't produce the needed cash, the corporation is insolvent.

It should be remembered that this chart covers all corporations. Thus, while many blue-chip companies are in fairly good shape and tend to pull the general average up, this obscures the fact that many lesser companies are in very bad shape and are pulling the average down.

The Administration's "solution" to the whole problem is to flood the nation with money and hope that the consumer will spend and that the corporations will then spend to keep up with the consumer. It may work that way, but I have my doubts. And the longer I stare at the charts, the greater the doubts.

FOREIGN MARKETS: Even as investors seek to protect themselves from the ravages of inflation via the Wall Street path, the pressure on European markets and economies mounts. Europe has, in the past, been through disastrous inflations, inflations which topple governments and wipe out the savings of years. And it is not about to give in to inflation so easily again.

Shown on this page are 10 leading foreign stock averages, nine if we exclude Canada which is in many ways economically tied to the U.S. Of the nine indices, not one is bullish in pattern. The two major producers of the Free World, aside from the U.S., are Japan and Germany. Both of their averages are at new 1970 lows. Joining them at new lows are Britain, Holland, Australia, Italy.

Ten years ago the U.S. existed as a mighty economic sun, around which the lesser satellites of Europe revolved in impotent economic consort. But the times have changed. Now, the direction of European economies can and will effect the course of the U.S. So far, the direction of these foreign stock averages tell me that Europe is resisting the inflation road, and has no intention of fostering synthetic boom come what may. The U.S. has chosen the other path. Something is going to give.

NOTES: Letter 481 presented a detailed study of the widening spread between top-grade and medium-grade bonds. This increasing spread points to deteriorating confidence on the part of bond buyers. It was therefore interesting to note that Barron's Confidence Index this week dropped to 86.6, a new low for the year, and the lowest level since 1964. This continuing decline in confidence should be reflected during 1971 in the stock market.

In closing, may I wish all my subscribers in this country and all over the world a very happy 1971. And may I add that true happiness has surprisingly little to do with money.